

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Ducheney Analyst: Jeani Brent Bill Number: AB 2328
Related Bills: See Legislative History Telephone: 845-3410 Introduced Date: 02/24/2000
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Biotechnology Or Technology Company Research Expenses Credit/Net Operating Loss/Allows Transfer Or Refund of Unused Tax Benefits

SUMMARY

Under the Bank and Corporation Tax Law (B&CTL), this bill would allow a biotechnology or technology company with unused tax benefits (research credit carryovers and NOL carryovers) to surrender those benefits to the state for a refund equal to 50% of the value of the unused tax benefit.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

AB 488 (as amended January 3, 2000) would have modified the research credit to allow a special allocation of a partnership's credit to specified biotechnology or technology companies. AB 488 also would have allowed a biotechnology or technology company with unused research credit carryovers or net operating loss carryovers to transfer (i.e., sell) those unused tax benefits to another taxpayer or surrender those benefits to the state for a refund. The surrender/refund provisions are identical to those contained in this bill. AB 488 was amended January 13, 2000, to remove the refund/surrender provisions. AB 488 failed to pass out of the first house by January 31 of the second year of this session.

AB 1315 (1999, as introduced) would have allowed the transfer of the manufacturers' investment credit (MIC) between affiliated corporations that file a single combined report. The MIC provisions were amended out on April 13, 1999.

AB 482 (1999) would have allowed taxpayers to assign to affiliated corporations the California seed capital and early stage corporation fund credit, which it would have created. AB 482 failed to pass out of the first house by January 31 of the second year of this session.

AB 1230 (1999) would have allowed a taxpayer that claims the research credit to transfer the credit to corporate taxpayers and would have required the department to develop a system for registering the transferred tax credits. AB 1230 failed to pass out of the first house by January 31 of the second year of this session.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Alan Hunter for GHG

4/4/00

SPECIFIC FINDINGS

Existing state and federal laws provide various tax credits that are designed to provide tax relief for taxpayers that must incur certain expenses (e.g., child and dependent care credits) or to influence behavior, including business practices and decisions (e.g., research credits).

Under existing state and federal laws, generally tax credits may be claimed only by the taxpayer that incurred the credit-related expense. In the case of the low-income housing credit, if a property is acquired during the credit period, the credit may be transferred to the acquiring taxpayer. In addition, for state purposes, a specific statutory authorization permits the low-income housing credit to be transferred between wholly-owned affiliated corporations.

Generally, a net operating loss (NOL) results when a taxpayer's business expenses exceed its net income in a particular year, thereby resulting in an "operating loss" for that year which is carried forward (or back, for federal purposes only) as a "net operating loss."

Under federal law, an NOL can be carried back to each of the two preceding years and carried forward to each of the 20 following years. **State law** generally conforms to the federal NOL provisions with three major exceptions:

(1) California law prohibits carry-back of the NOL deduction, (2) the carryover is generally five years, and (3) generally only 50% of the NOL can be carried forward.¹

Federal law treats an NOL as a tax attribute of the taxpayer. If a corporation with an NOL (the "loss corporation") ceases to exist as a result of a corporate acquisition (either a reorganization or a complete liquidation of a subsidiary), the successor corporation will stand in the shoes of the loss corporation with respect to the carryover and deduction of the NOL.

If an ownership change occurs in which the percentage of a loss-corporation's stock owned by 5% or more of the shareholders increases by more than 50 percentage points, then IRC Section 382 imposes a ceiling on the amount of the loss-corporation's NOL that can be deducted in any one year. The ceiling is the value of the loss-corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate.² The purpose of the ceiling is to prevent the buying and selling of NOLs that might occur if new owners were able to transfer profitable operations into a newly purchased corporation with unused NOL carryovers.

When a consolidated return is filed for **federal purposes**, NOLs generally are computed and carried back or forward on a consolidated group basis. Exceptions occur when corporations enter or leave the consolidated group.

¹ State law contains special NOL provisions for taxpayers that operate "new businesses" or "eligible small businesses;" suffer disaster losses; or that operate businesses within an enterprise zone, a local agency military base recovery area (LAMBRA), or a targeted tax area (TTA). These special NOL provisions are not discussed in this analysis.

² The long-term tax-exempt rate means the highest of the adjusted federal long-term rates in effect for any month in the three-calendar month period ending with the calendar month in which the ownership change occurs.

If an entering member has an NOL carryover from a pre-consolidation year (this is termed a "separate return limitation year," or SRLY), the NOL may be deducted only against the portion of the consolidated taxable income that is attributable to that corporation. If a corporation that generated a consolidated NOL carryover leaves the consolidated group, it takes with it an allocated portion of the group's unused NOL carryover.

California law does not conform to the federal consolidated return rules. Instead, California source income for corporations that operate both within and without the state is determined using unitary principles and combined reporting. As an alternative to the worldwide combined report, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally may exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. A fundamental difference between a California combined report (either worldwide or water's-edge) and a federal consolidated return is the concept of a group vs. separate entities. The federal consolidated return generally treats the group as a single taxpayer. The members of a California combined report are treated as a unit for purposes of combination and apportionment, but their separate entity status is preserved for all other purposes.

Unlike federal consolidated NOLs that are generally computed on a group basis, NOLS of members of a California combined report are separately computed. Each taxpayer member of a California combined report is attributed a share of the unitary group's California-source business income or loss (this is known as intrastate apportionment), which it aggregates with its own California-source nonbusiness income or loss. If the result is a net operating loss, that taxpayer will carry the NOL forward to be deducted against its California-source income in subsequent years. Because each member of a combined reporting group tracks and applies its own NOL, generally special rules are not needed to account for members entering or leaving the combined reporting group.

Under the B&CTL, this bill would allow a biotechnology or technology company with unused tax benefits (research and development credit carryovers and NOL carryovers) to surrender those benefits to the State for a refund equal to 50% of the value of the unused tax benefit. The maximum lifetime refund that may be received by a corporation and its affiliated corporations would be \$20 million. For purposes of this refund, a corporation is affiliated with the taxpayer if either the taxpayer directly or indirectly owns or controls 10% or more of the voting rights or 10% of the value of all classes of stock of that corporation or another organization directly or indirectly owns or controls 10% or more of the voting rights or 10% of the value of all classes of stock of both the taxpayer and that corporation.

Once unused tax benefits are surrendered by the taxpayer, the taxpayer would be prohibited from claiming those tax benefits on its tax return or surrendering those tax benefits more than one time. Taxpayers would be required to surrender the tax benefits and claim the refund only on an original or amended return.

The department would be required to maintain a cumulative total of the value of all unused tax benefits surrendered by all taxpayers for any income year. At least 30 days prior to the surrender, the taxpayer would be required to notify the department of the value of the unused tax benefit being surrendered.

The department would be required to notify the taxpayer if the value of the unused tax benefit exceeds the maximum annual amount that may be surrendered under the bill. The maximum annual amount for surrenders would be \$25 million per income year.

Constitutional Considerations

The requirement in this bill that a corporation must have either its headquarters or its base of operations in California likely would violate the Commerce Clause of the United States Constitution. Eligibility for the tax benefit surrender and refund would be limited to those taxpayers having their corporate headquarters or base of operations in this state. No regard would be given to the level of such taxpayer's taxable activity in this state, thereby discriminating against taxpayers having their corporate headquarters or base of operations outside of California.

Policy Considerations

This bill would set the maximum annual surrendered benefits at \$25 million per income year. Income years are not coextensive with calendar years or state fiscal years; taxpayers may choose to have their income year begin on any month of the year. As a result, different taxpayers have different income years. For example, income years for the year 2000 may begin in any month between January 2000 and December 2000, the later of which would end in November 2001. Therefore, there is a 23-month period between the beginning of the first income year and the end of the last income year for each calendar year (e.g., 2000). As a result, the bill would provide an inherent advantage to taxpayers with early income years because they would be able to surrender their tax benefits and claim the refund (on their original or amended return) before those with a later income year and before the annual aggregate maximum amount of refund would be reached. The \$25 million maximum amount of surrender and refund potentially could be reached before the taxpayers with later beginning income years are able to file their returns.

Historically, fraud has been associated with refundable credits (such as the state renter's credit, the federal Earned Income Tax Credit, and the federal farm gas credit).

This bill would provide a tax benefit for taxpayers filing under the B&CTL that would not be provided to other similarly situated taxpayers that file under the Personal Income Tax Law (PITL). Thus, this bill would provide differing treatment based solely on entity classification.

Implementation Considerations

Department staff has identified the following implementation considerations. These implementation considerations would make it very difficult, if not impossible, to properly implement this bill. Additional concerns may be raised as the department continues to analyze the bill. Department staff is willing to assist the author with any necessary amendments to resolve these concerns.

1. The department has not administered a refundable tax credit under the PITL since the refundable renter's credit was suspended in 1993. The department has never administered a refundable tax credit under the B&CTL. Establishing a refundable tax benefit process would have a significant impact on the department's programs and operations and require extensive changes to forms and systems.
2. A corporation and its affiliates would be limited to a maximum lifetime refund of \$20 million. Considering that a corporation may exist indefinitely and may have an unlimited and varying number of affiliates during those years, it would be difficult, if not impossible, for the department to ensure that the maximum lifetime refund limit is observed.
3. To administer the \$25 million maximum provision, the department would need to establish a tracking system to maintain a total of the tax benefits surrendered per income year. Moreover, the bill does not specify how the department is to allocate surrender authorizations to multiple unrelated taxpayers that file simultaneously for refunds that in the aggregate exceed the maximum annual limitation amount. In addition, if the amount of tax benefits refunded during an income year do not exceed the maximum annual amount, it is unclear whether the maximum amount could be transferred to the succeeding income year and thereby increase the next year's maximum amount.
4. This bill would provide a payment to a taxpayer in exchange for unused tax benefits. Although labeled a refund, the payment has no connection to taxes previously paid. The tax treatment of this payment is unclear. For example, if the refund were considered a contribution to capital of the corporation, it would be nontaxable under federal and state tax law. However, a contribution of capital in the form of money requires a reduction in the basis of certain property held or acquired by the corporation.
5. This bill specifies that a taxpayer may surrender the tax benefits and claim a refund on an amended tax return. However, this bill leaves unclear whether taxpayers could surrender tax benefits and claim refunds only for the current year or whether the taxpayer could request a refund for any tax year not barred by the statute of limitations.
6. This bill uses various terms that are not defined, such as "highly educated," "highly trained," "corporation business taxpayer," "headquarters," and "base of operations." Further, terms are used inconsistently and in an unusual context that add confusion to the provisions. Undefined terms and unclear definitions can lead to disputes between taxpayers and the department.
7. This bill does not address whether the entire unused tax benefit only or portions of the unused tax benefit may be surrendered for refund.
8. It is unclear whether the department could reduce or offset refund amounts for other amounts owed.

9. It is expected that the department would manually review the claims for refunds and attached documentation since the refund amounts could be significant.

Technical Considerations

In defining "unused tax benefits," this bill refers to provisions of Section 23609, which prescribe carryover rules, but erroneously references subdivision (d) of Section 23609 rather than subdivision (f).

The bill refers to a biotechnology or technology company's applicable "**allocation**" factor, but references the "**apportionment**" rules. It appears that the word "apportionment" should be properly substituted for the word "allocation" if that is consistent with the author's intent.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved.

Tax Revenue Estimate

The revenue impact for this bill is shown below:

Revenue Impact of AB 2328 Assumed Enacted after 6/30/2000 Losses in \$ Millions			
2000-01	2001-02	2002-03	2003-04
-\$25	-\$25	-\$25	-\$25

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Estimate Discussion

The revenue impact of this proposal depends on the stocks of unused research credit and NOL carryover and the amounts of these stocks that would be surrendered for refund. The revenue loss is limited to \$25 million per fiscal year.

Stocks of unused research credits and NOL carryover for biotechnology and technology corporations were estimated based on recent corporate tax return data. The revenue impact was estimated as the product of these stocks with the surrender percentages and, in the case of NOL carryovers, apportionment factors and tax rates. For the income year 2000, the estimated stocks of qualified unused research credits and tax benefits of NOL carryovers are \$450 million and \$50 million respectively. The surrender percentage was assumed to be 50%. From these unused credit and NOL stocks, the revenue loss without any refund limit for fiscal year 2000-2001 would be \$125 million (\$500 million times the assumed surrender proportion (50%) times the surrender price (50 cents on the dollar)). However, due to the refund limit, the revenue loss would be \$25 million per fiscal year.

BOARD POSITION

Pending.